Ukraine: Delayed policy response to sharply higher risks

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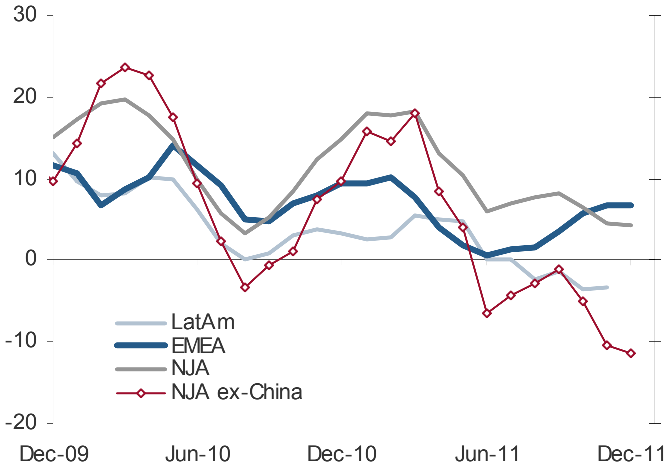
EMEA IP outperformed other EM regions and the euro zone

IP: EMEA vs. the rest of EM

3m/3m % annualized, seasonally and workday adjusted

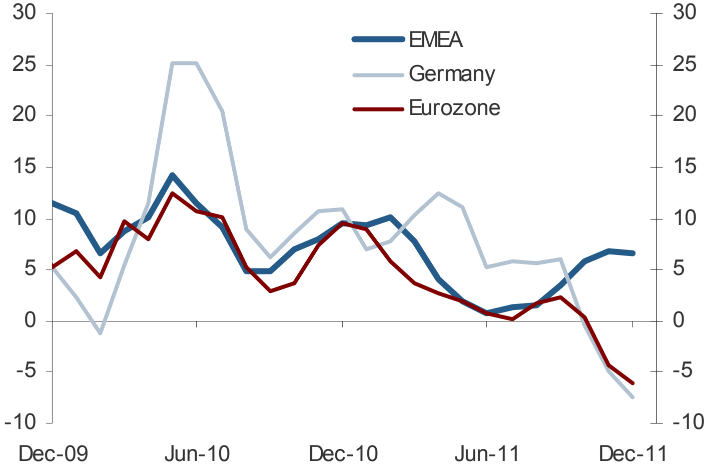


Note: We weight data for eight EMEA countries by their 2010 nominal GDPs: Czech Republic, Hungary, Poland, Romania, Russia, South Africa, Turkey and Ukraine

Source: Haver Analytics®, Credit Suisse

IP: EMEA vs. the euro zone and Germany

3m/3m % annualized, seasonally and workday adjusted



Note: We weight data for eight countries by their 2010 nominal GDPs: Czech Republic, Hungary, Poland, Romania, Russia, South Africa, Turkey and Ukraine

Source: Haver Analytics®, Credit Suisse

- **The EMEA region's industrial output growth momentum stands out from the rest of EM ex-China. EMEA's manufacturing PMI increased slightly in January and broadly stabilized around 51.0 during the last five months, coinciding with the improvement in the region's IP growth momentum.**
- **Poland and Turkey remain the leading economies in the region in terms of the pace of industrial output growth. In Russia, industrial output growth momentum remains subdued, due mainly to the weakness in external demand. Russia's domestic demand indicators were robust in December before easing somewhat in January.**
- **The Q4 2011 pick-up in industrial output growth momentum in the Czech Republic and Hungary in Q4 remains vulnerable to a slowdown in the industrial output dynamics in the euro area.**

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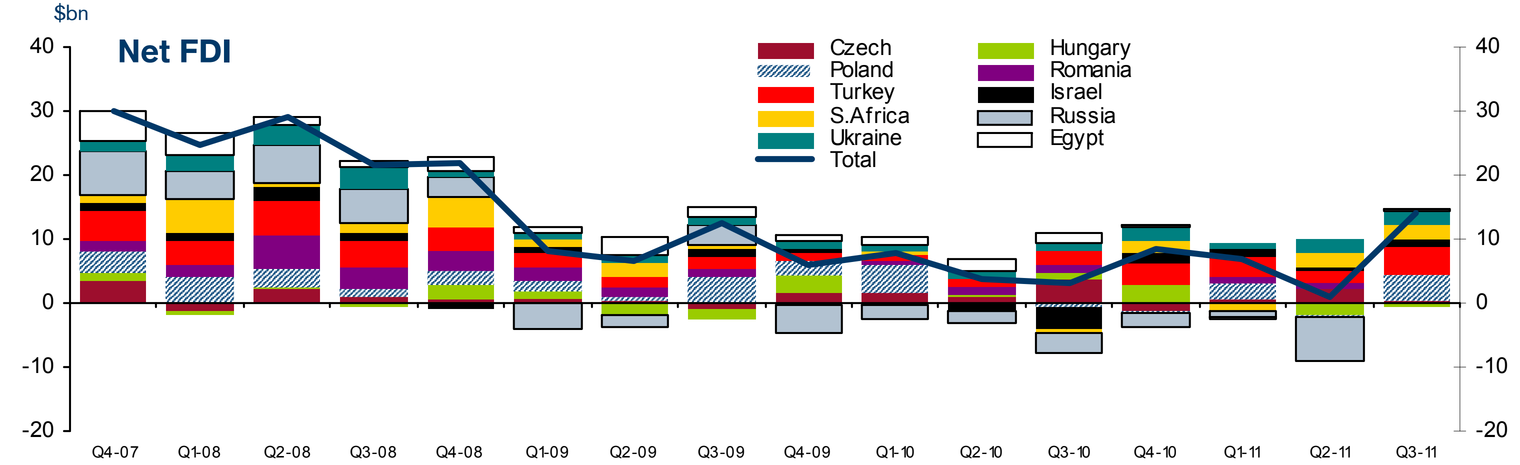
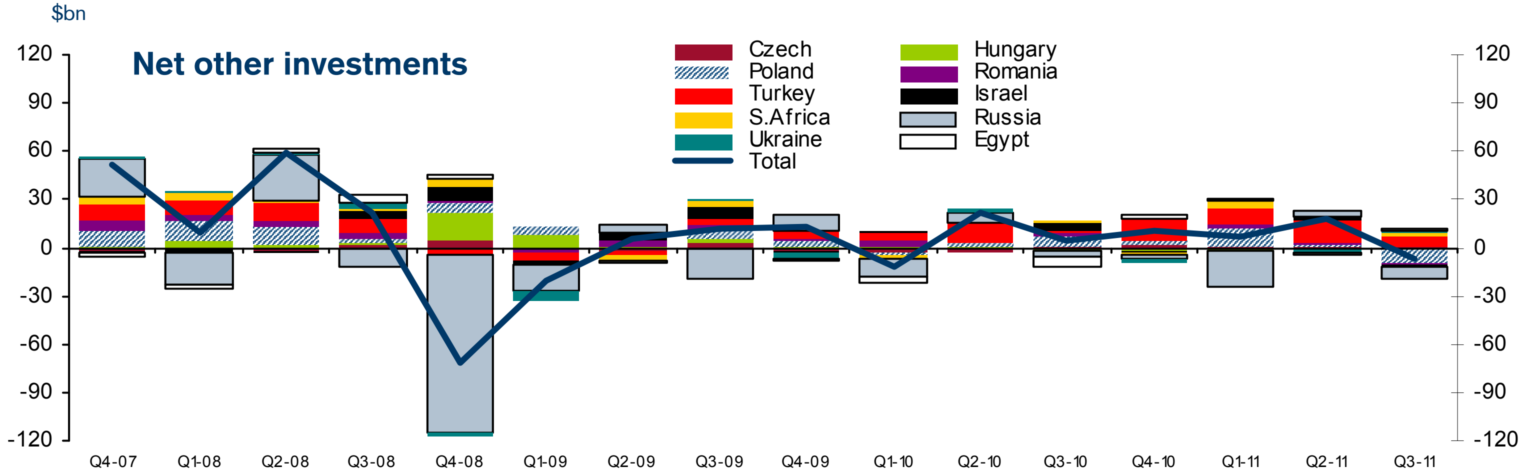
Weak cross-border capital inflows in the EMEA region

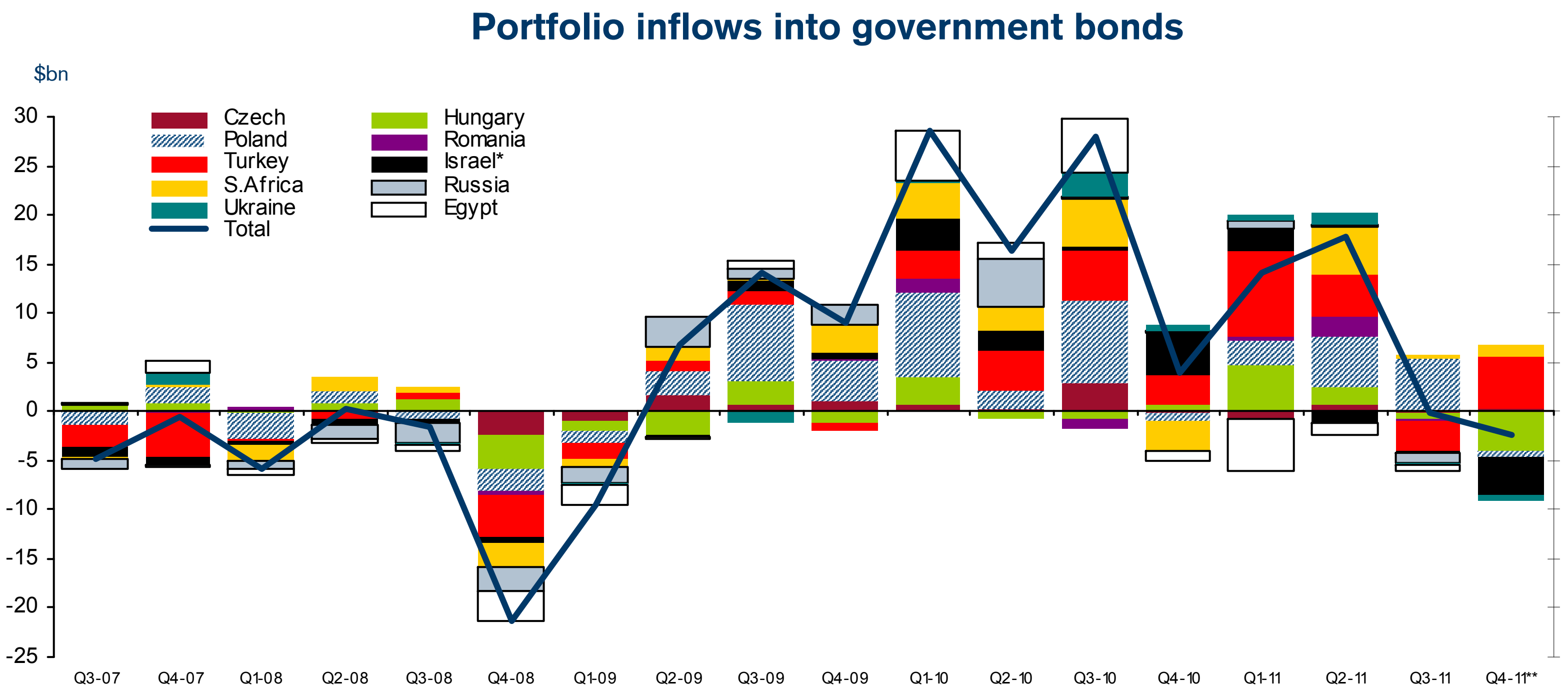




Source: IMF Balance of Payments Statistics, national authorities, Credit Suisse

- **Net FDI and other investment inflows (mainly comprising cross-border loans) which boosted growth rates in the capital-deficient EMEA region before the global crisis are still struggling to recover to pre-crisis levels.**

Inflows into EMEA government bonds turned into outflows



*Includes makam bills. **CS estimates. These comprise governments' net Eurobond issuances and changes in foreigners' holdings of local-currency government debt.

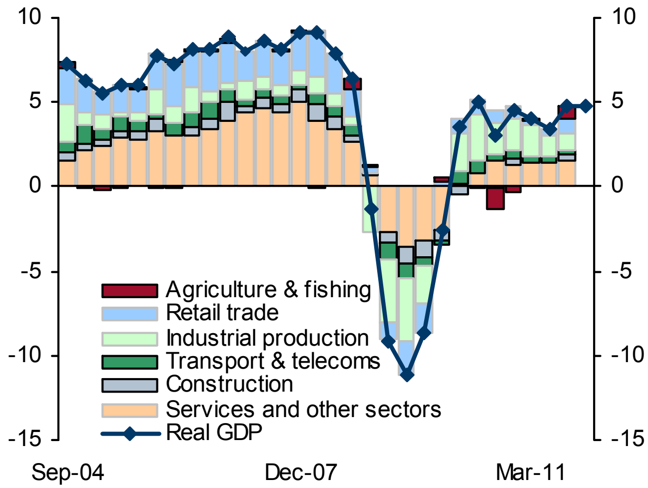
Source: IMF Balance of Payments Statistics, national authorities, Credit Suisse

- **There were outflows of \$0.2bn in Q3 2011 and an estimated \$2.4bn in Q4 2011 from EMEA government bonds, following strong inflows of \$17.7bn in Q2 2011. The inflows into EMEA government bonds were as high as \$28.0bn in Q1 2010 and Q3 2010.**
- **The EMEA countries which attracted the most portfolio inflows into government bonds in 2011 were Turkey (\$15.3bn in total, \$13.1bn in H1), Poland (\$12.3bn in total, \$7.5bn in H1), South Africa (\$6.4bn in total, \$4.7bn in H1) and Hungary (\$2.1bn in total, \$6.7bn in H1).**

Russia: growth slowdown in 2012 is very likely

Contributions to real GDP growth, quarterly

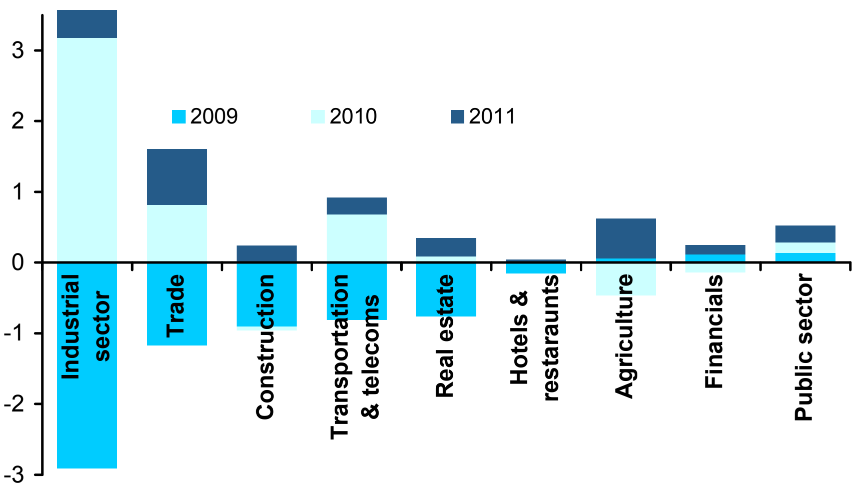
pps, except for % year-on-year change in real GDP



Source: Rosstat, Economy Ministry, Haver Analytics, Credit Suisse

Contributions to real GDP growth, annual

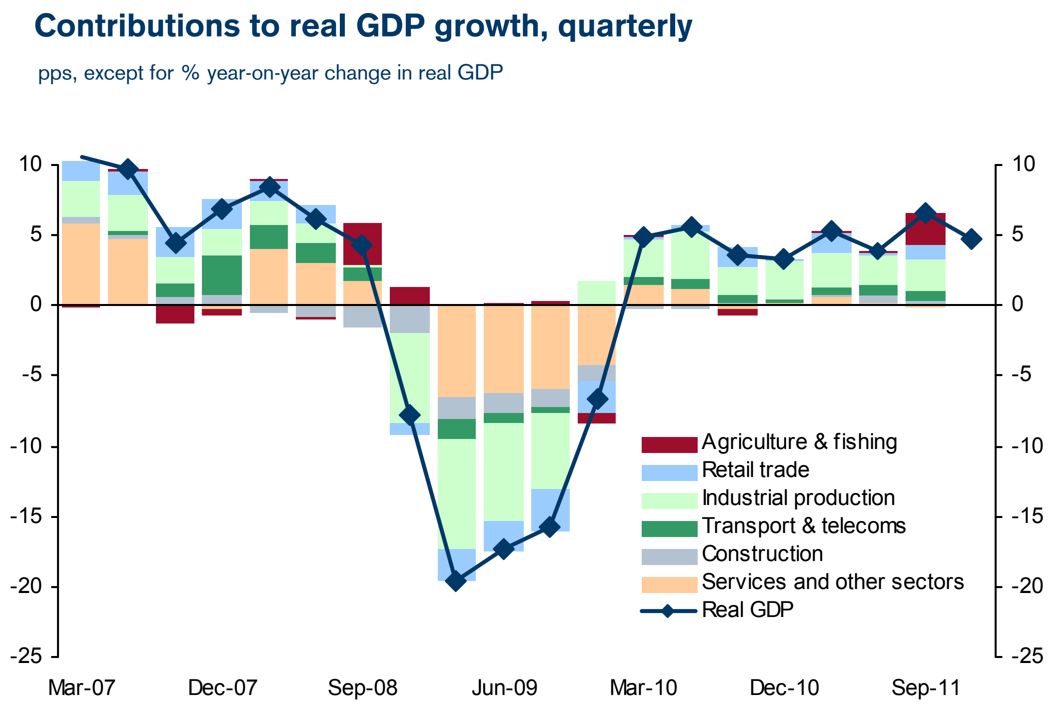
Percentage points



Source: Rosstat, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

- **In Russia, the largest increase in the contribution to real 2011 GDP growth (which totalled 4.3% yoy, for the second consecutive year) came from agriculture, thanks to a good harvest. Industry's contribution fell sharply, to 1.0pp, from 3.2pp in 2010.**
- **We see only limited scope for a stronger contribution to growth from the industrial sector in 2012, consistent with our expectation for a slowdown in real GDP growth this year to 3.8% yoy. However, we see material risks of a more significant slowdown in Russia's growth this year.**

Ukraine: Q3 2011 spike in GDP growth harvest-driven



Source: State Statistics Agency, Credit Suisse

- **Real GDP growth slowed in Q4 2011 to 4.7% yoy (0.5% qoq in seasonally adjusted terms), after 6.6% yoy (2.2% qoq sa) in Q3 and 3.8% yoy (0.5% qoq sa) in Q2, due mainly to sharply weaker external demand. With agricultural output contributing 2.3pp to Q3 2011 growth, the performance of the non-agricultural part of the economy over the last three quarters was fairly lackluster, in our view.**
- **GDP growth prospects in 2012 are very uncertain due to weather-related disruptions to output and exports early in the year and a projected decline in agricultural output due to a much harsher start to the new grain season. The central bank estimates January 2012 GDP growth at about 2% yoy.**

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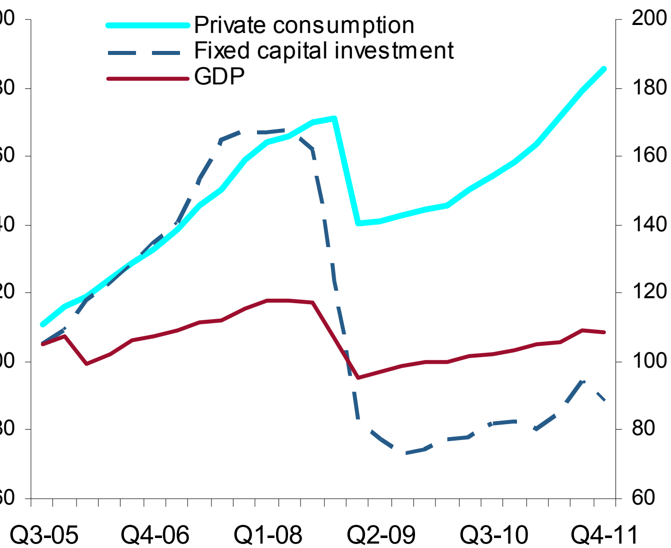
Ukraine's growth has been led by consumption recently

Output indicators

Note: The NBU's key sectors indicator covers 72% of GDP.

Source: State Statistics Agency, NBU, Credit Suisse

GDP and key components



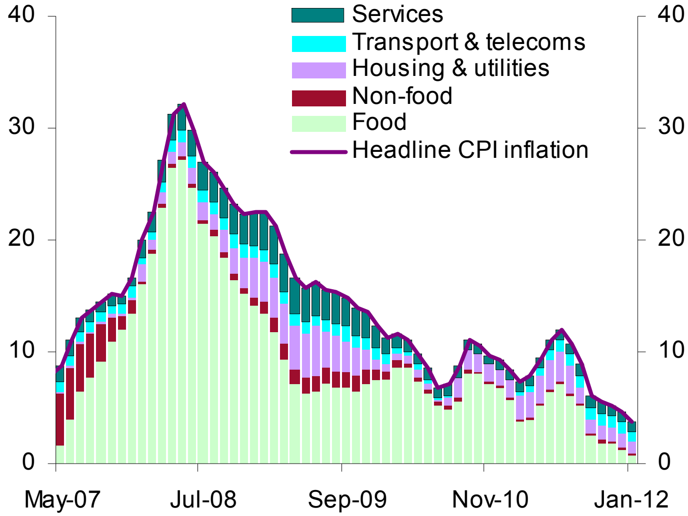
Source: State Statistics Agency, Credit Suisse

- **After weak Q4 2011 performance, IP growth was positive in January. On a 3-month moving average basis, we estimate seasonally adjusted growth at 0.2% mom last month, after -0.6% mom in November and -0.8% in December. The sharpest increase was in the utilities sector (3.4% yoy), due to weather-related demand. Metals output was subdued (-1.6% yoy, after -4.7% yoy in December). We expect both IP and exports to be weak in February, due to weather-related disruptions and despite the continued strength of demand for energy.**
- **Demand-side GDP data pointed to consumption-led growth most recently, while the performance of fixed investment has been uneven.**

Ukraine's remarkable disinflation: how sustainable?

Contributions to headline year-on-year CPI inflation

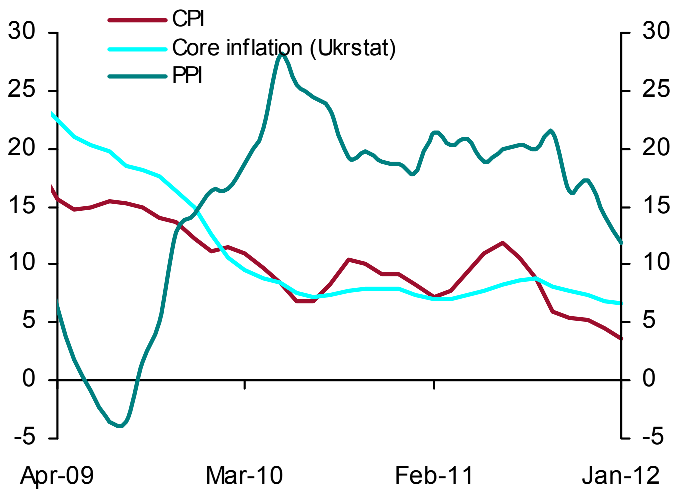
pps, except for % yoy change in CPI



Source: State Statistics Agency, Credit Suisse

Consumer and producer prices and core inflation

% year-on-year change



Source: State Statistics Agency, Credit Suisse

- **Inflation fell to an 8-year low of 3.7% yoy in January 2012, from 4.6% yoy in December 2011, thanks mainly to the continuing declines in food price inflation on the back of last year's bumper harvest. However, inflation is very likely to rebound later in the year, in view of unfavorable base effects, a likely decline in agricultural output and spending pressures ahead of the parliamentary elections in October 2012.**
- **The sharp decline in inflation recently was due at least in part to new CPI basket weights that reduced the share of food products but also increased the weight of imported goods in the CPI. This should lead to a higher pass-through effect from changes in the exchange rate, increasing the impact on inflation of potential currency depreciation.**

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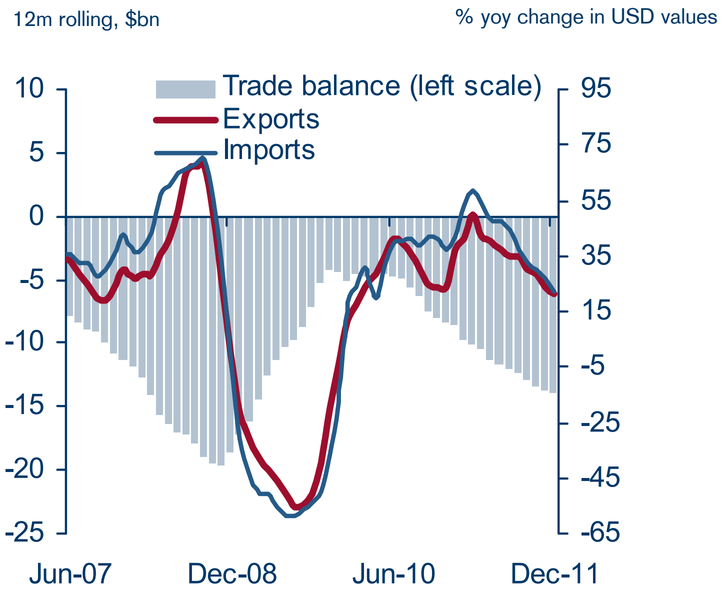
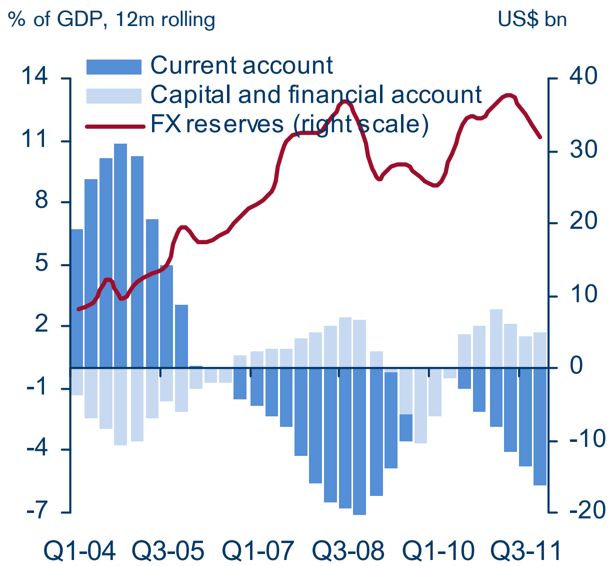
Rising current account deficit: Ukraine's Achilles' heel

Merchandise trade



Source: State Statistics Agency, Credit Suisse

Current and capital account , FX reserves



Source: National Bank of Ukraine, Credit Suisse

- **The current account deficit widened to 5.6% of GDP in December 2011 from 2.1% of GDP in December 2010 , due mainly to sharp increases in the value of energy imports. The 12-month goods trade deficit was at 8.4% of GDP in December 2011.**
- **December BoP data painted a slightly less negative picture compared to the previous several months, thanks mainly to a further slowdown in import growth, as well as lower household purchases of FX.**
- **However, the bill for energy imports looks set to rise in Q1 2012, due in part to the impact of very cold weather, while export values will likely be curbed due to stagnant metal prices and export volumes. Accordingly, the deterioration of the current account is very likely to continue in 2012, aggravating a key credit vulnerability.**

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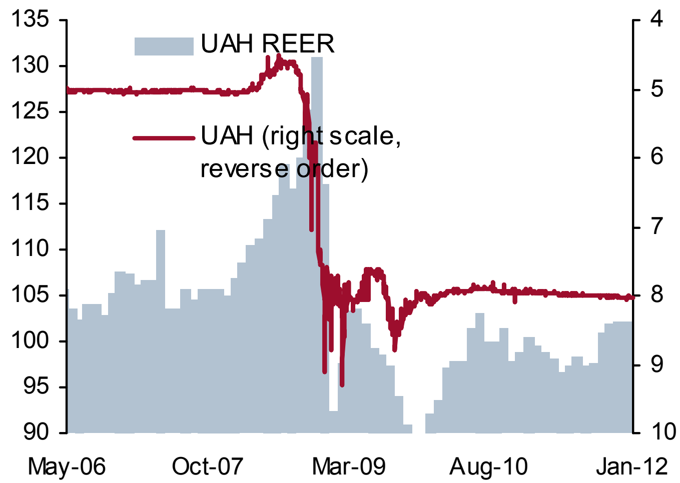
UAH/USD peg fuels volatility of FX reserves, interest rates

Hryvnia's exchange rates

UAH REER* (2001 = 100) UAH per USD, spot

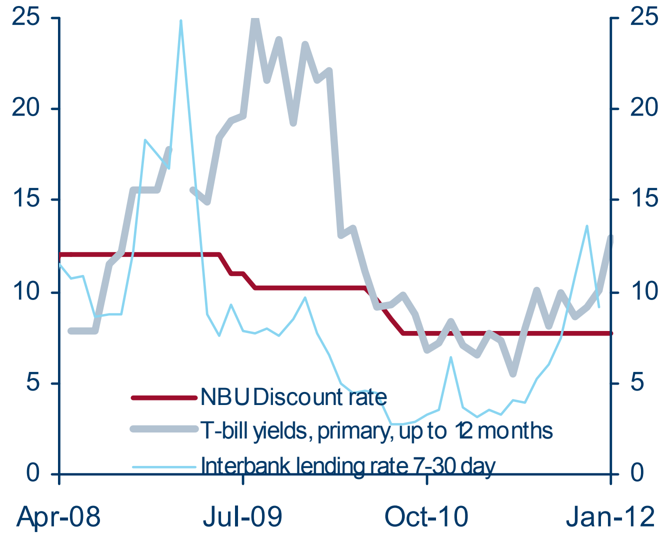


*Real effective exchange rate; an increase denotes appreciation.

Source: the BLOOMBERG PROFESSIONALTM service, Credit Suisse

Interest rates

% p. a.



Source: National Bank of Ukraine, Credit Suisse.

- **The volatility of the exchange rate has declined since the beginning of 2011. The central bank's determination to maintain the currency peg in the face of weaker demand for key export products risks a prolonged spell of declining reserves. This risk is now a concern both for multilateral and portfolio investors.**
- **Market interest rates surged in 2011, reflecting the tight liquidity situation and concerns about a possible devaluation. In late January 2012, the central bank cut some of its policy rates (but not the discount rate) by 25 bps, the first such move since 2009.**

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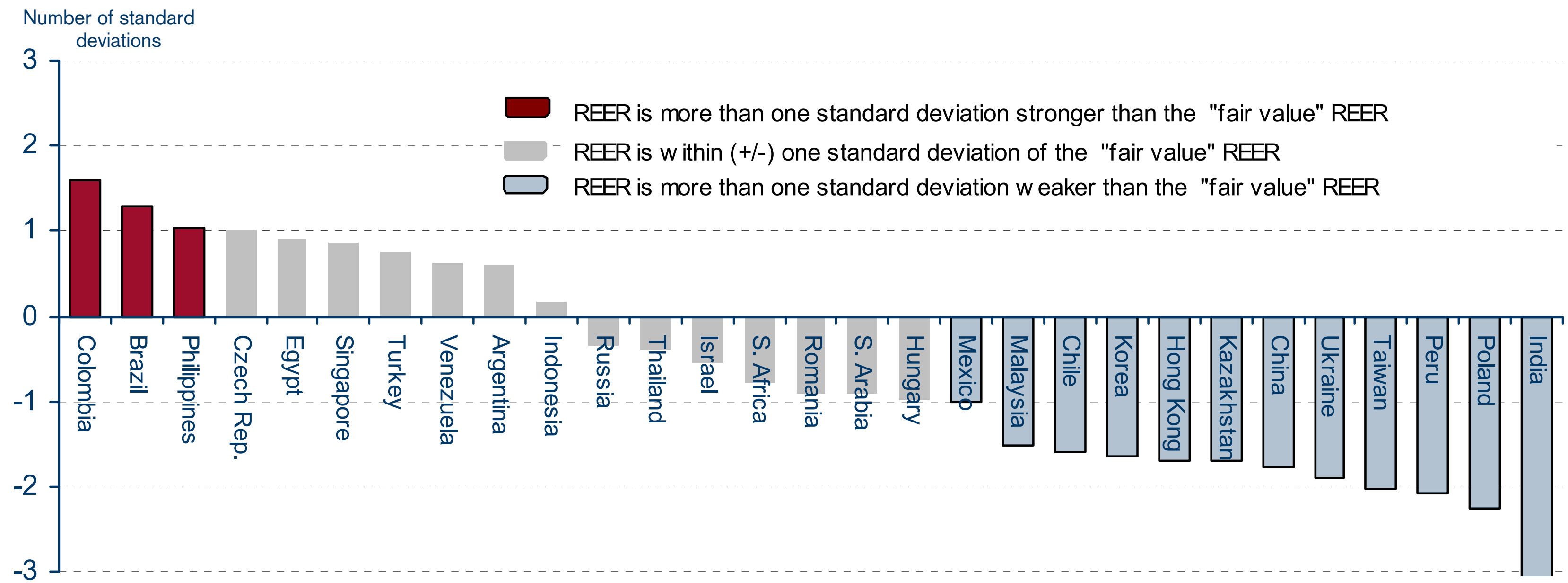
Among other EM currencies, hryvnia still looks “cheap”

Deviation of real effective exchange rates (REER) from our model-based fair value estimates as of 7 Feb 2012

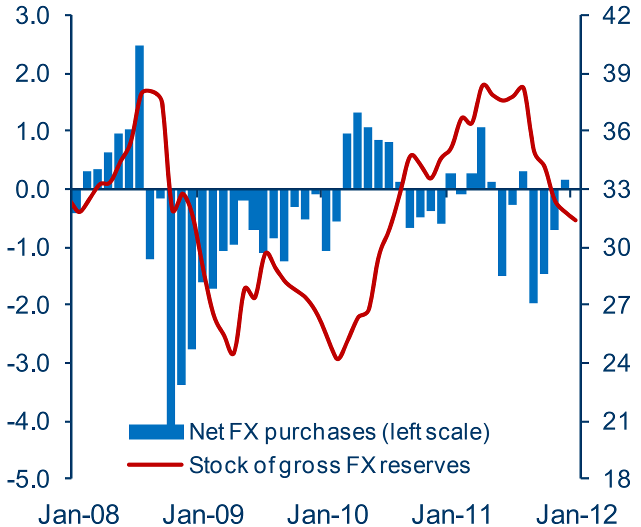


Source: Credit Suisse

- **Ukraine’s hryvnia, alongside the Polish zloty and the Kazakh tenge, are the only EMEA currencies that appear cheap to our fair value estimates for REER.**
- **However, the rapid widening of Ukraine’s current account deficit underscores the need for the central bank to allow for the exchange rate to cushion at least some of the impact of the worsening external position.**
- **The apparent political preference for a rigid peg raises the risk of further FX reserve losses and a large-scale exchange rate adjustment either side of the parliamentary elections (due in October 2012).**

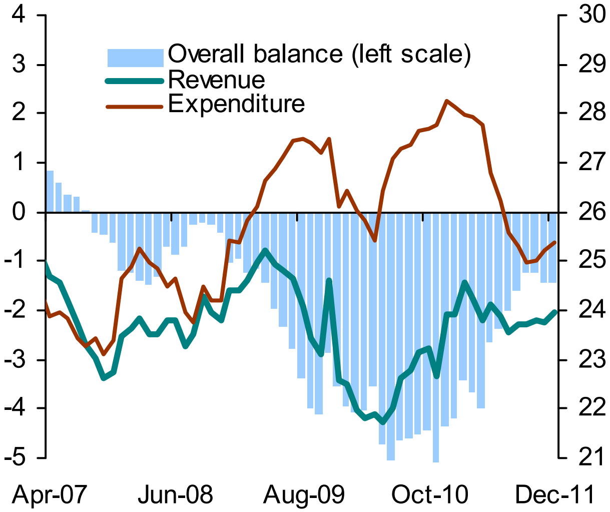
Twin deficits underscore the dearth of financing sources

FX reserves, interventions



Source: National Bank of Ukraine, Credit Suisse

State budget operations



Source: Finance Ministry, Credit Suisse

- **The loss of FX reserves slowed in December 2011, after some $3bn of combined central bank interventions over the preceding 3 months. However, the stock of gross reserves fell by $430mn in January 2012, to $31.4bn (3.5 months of import cover), below the pre-crisis high ($38.1bn) in August 2008.**
- **The state budget performance in late 2011 was appropriate, with the officially reported deficit of the state budget (net of Naftogaz subsidies) at just 1.8% of GDP. At the same time, the operational deficit of Naftogaz totalled some 1.2% of GDP in 2011, and can be reduced only via higher domestic tariffs or a significant reduction in import gas prices. However, reaching a new gas supply agreement with Russia has proven difficult thus far.**

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Risk of a potentially large loss of FX reserves this year

Ukraine: Balance of payments financing needs and sources

$bn	2009	2010	2011E	2012F
Funding need (including short-term debt amortization)	**40.6**	**40.7**	**49.8**	**53.6**
Funding need (excluding short-term debt amortization)	**19.3**	**22.3**	**27.9**	**32.9**
Current account deficit	1.7	2.9	9.3	11.1
External debt amortization	17.4	19.2	18.3	21.3
Public	3.0	3.3	3.8	6.3
Private	14.4	15.9	14.5	15.0
FDI outflows	0.2	0.2	0.3	0.5
Short-term debt	21.3	18.4	21.9	20.7
Funding sources (including gross short-term borrowing)	**40.6**	**40.7**	**49.8**	**53.6**
FDI inflows	3.6	5.1	6.3	7.5
Portfolio investments	0.3	0.3	0.3	0.5
Medium- and long-term borrowing	4.5	9.5	17.5	15.5
Short-term borrowing and other flows	18.4	21.9	20.7	21.2
Other (including multilateral financing)	8.1	7.5	0.0	0.0
Change in net international reserves (- indicates increase)	5.7	-3.6	5.0	8.9
Memo item:				
Nominal GDP ($ bn)	113.7	128.4	164.5	173.2

Source: central bank, Credit Suisse

- **The public sector needs to repay some $3.8bn to the IFIs in 2012, besides the $2bn loan from VTB (due in June 2012) and a $0.5bn Eurobond (also in June). Additionally, the private sector will need to roll over some $15bn.**
- **Assuming no breakthrough in talks with the IMF, Ukraine would need to refinance $2.5bn of sovereign debt without assistance from multilateral lenders and ideally raise $1.0bn or more in net terms. The timing of FX inflows related to the EURO-2012 tournament (in June-July 2012) should help reduce the overall BoP deficit during a peak FX redemptions period.**

In absence of IMF funds, Russia's support would be key

Government funding needs and sources

UKRAINE	2009		2010		2011E		2012F	
	$ bn	% of GDP	$ bn	% of GDP	$ bn	% of GDP	$ bn	% of GDP
Total borrowing requirement	**14.4**	**12.7**	**13.2**	**10.3**	**10.3**	**6.3**	**11.6**	**6.7**
Overall fiscal deficit*	5.6	4.9	7.0	5.5	3.0	1.8	3.9	2.3
Primary fiscal deficit	3.8	3.3	5.0	3.9	-0.1	-0.1	0.2	0.1
Interest payments	1.7	1.5	2.0	1.6	3.1	1.9	3.7	2.1
Total amortization payments	5.8	5.1	4.3	3.4	5.3	3.2	7.6	4.4
Domestic debt	3.3	2.9	3.5	2.7	3.6	2.2	3.8	2.2
External debt	2.5	2.2	0.8	0.6	1.7	1.0	3.8	2.2
Naftogaz operational deficit	3.0	2.6	1.9	1.5	2.0	1.2	0.1	0.1
Funding sources	**14.4**	**12.7**	**13.2**	**10.3**	**10.3**	**6.3**	**11.6**	**6.7**
External	6.2	5.5	5.5	4.3	2.8	1.7	3.5	2.0
Domestic financing sources, of which	8.0	7.0	7.3	5.7	6.3	3.8	6.8	3.9
Gross domestic borrowing	2.1	1.8	5.4	4.2	6.2	3.8	6.6	3.8
Drawdowns on fiscal deposits	5.7	5.0	-1.9	-1.5	0.1	0.1	0.2	0.1
Privatization	0.2	0.2	0.4	0.3	1.3	0.8	1.3	0.8
Memo item:								
GDP ($bn)	113.7		128.4		164.5		173.2	

*Excluding bank recapitalization costs and Naftogaz balances

Source: National Bank of Ukraine, Finance Ministry, Credit Suisse estimates

- **Ukraine's government funding needs in 2012 also look challenging, given the lack of progress in the talks with the IMF. Besides the $1bn due to the IMF from the government, Ukraine is also facing the need to refinance the $2bn VTB loan maturing in June 2012 and the $0.5bn Eurobond (also in June).**
- **The likelihood of a new issue of some $1.7bn of Eurobonds in Q1 2012 (targeted by the government) appears low to us. Accordingly, the government would have to rely primarily on domestic borrowing and Russia-related financing sources, in our view.**

Disclosure Appendix

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